BETTER ESG-SCREENING, HIGHER ON FEES AND RETURN LAGS BEHIND

Sustainable investment funds deliver on ESG but not always on returns

European investors research

Investment funds are reasonably successful in making sound investments with investors' money. This comes at a cost and so far there appears to be no link between sustainability and returns.

Times are hard for those offering active investment funds. These funds invest the money of a large number of investors in carefully selected businesses or financial products.

Making that selection costs money because an investment team has to investigate a great many possible investments to be able to make the right choices. The cost of this is passed on to investors in the form of annual costs. For years these relatively high costs did not appear to correlate with better returns from active funds compared with trackers, listed index funds that are generally quite a bit cheaper. Something which for some years made active funds less popular relative to trackers.

With the growing popularity of sustainable investment, active investment funds sense renewed opportunities. Because it is not really clear precisely which investments are sustainable, it is difficult for funds to offer products that are demonstrably sustainable.

This notion was supported by a recent European Investors' study of all European trackers in the field of ESG. Investing in sustainability through trackers (ETFs) still often means investing in large tech businesses, like Microsoft and Google, but also in oil companies or the automotive industry.

Active investment funds believe they are in a better position when it comes to sustainable investment. Because fund managers analyse and follow companies closely they should have a clearer view of how much attention these businesses devote to climate, social and governance issues.

We put this to the test by analysing the investment policy, costs and returns of the more than 400 sustainable investment funds available in Europe. Most sustainable funds are actively managed (90 percent). Parties such as Robeco, Hermes, Comgest, Amundi and ASR are the major providers. In the area of passive funds, Northern Trust and ACTIAM (formerly SNS) offer the majority.

In the same way as EFTs, these funds follow the index but do not have the option of stepping in or out during a trading day, for example.

European Investors

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TOP 10 FUNDS WITH THE HIGHEST ESG SCORES

#	ISIN	Name	Fund assets (EUR m)	5yr return (per year, after costs)
1	NL0009347574	Sustainable Europe Index Fund	514	6.58%
2	DE000A0JM0Q6	LBBW Nachhaltigkeit Aktien I	122	6.55%
3	DE000DWS08X0	Bethmann Nachhaltigkeit	159	4.93%
4	ES0138885035	Fonengin ISR A FI	175	0.94%
5	ES0138516036	Microbank Fondo Ético Estándar FI	61	2.13%
6	AT0000645973	ERSTE Responsible Stock Europe € R01 T	109	2.61%
7	NL0009347566	Sustainable World Index Fund	82	9.32%
8	AT0000677901	Raiffeisen-Nachhaltigkeitsf-Aktien R A	251	9.28%
9	IE00B7FQWQ16	Northern Trust Euro Cust ESG Eq Idx B	1,028	3.43%
10	DE0009847343	terrAssisi Aktien I AMI P a	174	8.70%

Source: Morningstar, excluding funds smaller than €50 million.

SELECTION

Active investment funds should be able to stand out by making a carefully considered selection of shares in companies that are truly sustainable. How they do that is not always clear. Funds provide few details about this in their documentation. The fund manager can carry out an independent analysis of companies, but it may be ventured that they also readily make use of their own internal rating systems which are often fed with

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Our research

- This study focused on the available range of (open-ended) sustainable investment funds for sale in Europe.
- This included more than 400 main funds with a jointly managed capital of €125 billion.
- To make this sustainable selection, we looked at the investment mandate pursued and whether the prospectus for each fund bore the epithet of sustainable (ESG) or environmental.
- The oldest share classes were looked at each time and the fund variation given in euros was used to calculate costs and the return.
- This study used information provided by investment funds and companies, as well as information and data provided by Bloomberg and Morningstar.

data from external suppliers in the area of ESG.

Suppliers of this type of information, such as Sustainalytics, MSCI and ISS-oekom, meet the information demand using a wide range of databases and by publishing sustainability scores.

By issuing scores they are increasingly adopting the role of rating agencies which play an important role in determining the credit-worthiness of a company, but then applied to sustainability.

To obtain data on sustainability the data providers essentially have to rely on what publicly-listed companies themselves state and whatever they can find from public sources, such as the internet. While there are no standards and definitions, there is a risk that the data obtained is either not comparable or incorrect.

It is important for investors to have a clear understanding of the background to the ESG scores that have been issued. This is clear from a list of the most sustainable European investment funds based on the data of just one ESG rating organisation.

MOST SUSTAINABLE FUNDS

In the same way as companies, funds can also be awarded an ESG score. Individual companies' ESG scores are included in the overall portfolio scores on the basis of their relative allocation in the sustainable investment portfolio. Taking this as our measure we looked at which funds are the most sustainable in Europe according to the data provider Sustainalytics.

The high scores of the Dutch asset management company InsingerGilissen - which has two funds in the top 10 - are particularly notable. Its Sustainable Europe Index Fund is in first place and over the past five years has achieved an average return of 6.6 percent.

It is also clear that not all the funds in this top 10 are equally sustainable. InsingerGilissen's Sustainable Europe Index Fund invests a substantial proportion of investors' money in the oil and gas industry. The French company Total is the fourth largest investment made by the fund.

The number two on the list, the LBBW share fund, similarly invests in the automotive manufacturer Daimler (50,000 shares, 1.9 percent of the portfolio).

Clearly in practice it is difficult to select companies that are fully sustainable. Companies have both positive and negative dimensions.

An example of this is the distiller Diageo, an investment which appears in the portfolios of dozens of sustainable funds, especially funds with a European orientation. The originally British company is known for its alcoholic beverages, such as Smirnoff, Johnny Walker and Guinness beer.

Viewed from an ESG perspective the whisky producer could be considered to be high risk because the product range comes with an inherent social risk of alcoholism. But the company is also a frontrunner in the area of gender equality; it has a generous parental leave scheme and many diversity and inclusion programmes. And therefore Diageo has a good 'S' score in ESG.

The adding and deducting of ESG elements fits with the idea of compensation where companies with an inherent ESG risk that affects the earning model can repair the downside effects by doing things that are good for society. Although technically it is possible to explain this method, investors also often have certain perceptions with regard to sustainable investment which go beyond this balancing act. Sustainable fund providers still have some work to do if they want to be able to draw on that sentiment.

BUYING FUNDS

It is not easy for European investors to choose freely from among all the available funds. An individual investor wanting to invest in a Spanish sustainable fund that is not actively offered in the Netherlands through a broker will have to open an investment account in Spain. It is important to note that the documentation will be mainly in Spanish too

Investors also have a choice in their own country. It appears that Dutch fund providers are highly active in sustainable investment. To give an impression of the available range, a shortlist of relevant funds based on ESG scores and returns is given below (Table 2). The list does not include fund providers without an ESG score. This does not mean that these funds are any less green however. The reason why some funds do not have an ESG score is that the rating agencies have not looked closely enough at the underlying investments. This appears to be a temporary problem, however, given the rapid increase in the number of companies covered.

Investors have the onerous task of finding their own way through the rapidly changing investment landscape in which sustainability is increasingly gaining ground. European Investors will monitor these developments closely and judge sustainability claims on the basis of their merits.

SPREAD AND COSTS

Compared with the sustainable ETFs investigated last time, it appears that active sustainable investment funds do a better job of making their allocations. Sustainable funds, for example, invest in fewer controversial companies like the traditional automotive industry and in fossil fuels. Clearly active managers are better at identifying companies with an inherent ESG risk or some other controversy in good time and keeping them out of the portfolio. The active funds would therefore appear to be more sustainable than the ETFs.

This better selection comes at a price, however. The costs associated with sustainable investment funds are high, on average. The average annual cost, given here as the net expense ratio, amounts to 1.5 percent per year, rising to 3.6 percent per year (see Graph 1).

Compared with the previously investigated sustainable ETF trackers, sustainable investment funds are considerably more costly. While it was quite possible to find a tracker among the ETFs with a cost factor of 20 to 40 base points a year, this is quite a bit more difficult among the open-ended offerings.

Because costs have such a major impact on the final return, investors would do well to take a close look at the cost structure. To be able to do that investors need to study the prospectus, the document drawn up when an investment fund is launched. In doing so it is worthwhile to check whether there may be a temporary discount on the management costs; sometimes it may be stated that this will end soon.

SUSTAINABLE FUNDS OFFERED BY DUTCH PROVIDERS

ISIN	Fund name	2 yr return (per year)	5 yr return (per year)
NL0009347574	InsingerGilissen Sust Europe Index Fund	6.95%	6.58%
NL0000441301	ASN Duurzaam Aandelenfonds	6.28%	9.29%
NL0000289783	Robeco Sust Glbl Stars Eqs Fd EUR	10.34%	9.57%
NL0012294151	ASR ESG IndexPlus Inst Eurp Andln C	4.52%	-
NL0011309315	ACTIAM Verantwoord Index Aand. Europa	4.12%	-

Source: Bloomberg, Morningstar

DISAPPOINTING RETURNS

The ultimate challenge for sustainable investment funds is being able to combine social, climate-related and governance issues with good returns. Although sustainable funds are still relatively recent, for the moment it is such that the market returns are disappointing.

The return provided by more than 90 percent of the sustainable funds on offer, as they currently stand, lags behind that of the standard S&P 500 when a sustainable fund is compared with the world's most popular tracker.

When the comparison is restricted to the sustainable world, then the share funds perform best on average. Half the funds manage to achieve 8.2 percent per year or more, after costs are deducted.

IT APPEARS THAT DUTCH FUND PROVIDERS ARE HIGHLY ACTIVE IN SUSTAINABLE INVESTMENT

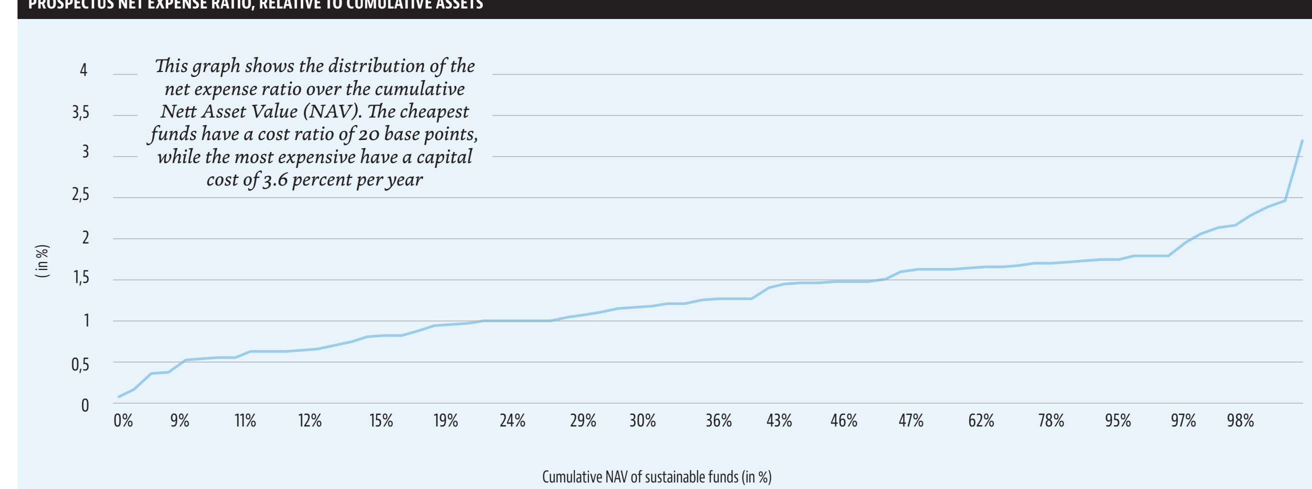
Fixed-rate sustainable funds achieve 1.8 percent on average, which viewed in the light of declining interest rates is relatively little but is still close to the index (2 percent).

Allocation, a mix of both shares and bonds, performs marginally better with a return of 2.2 percent per year.

The disappointing return can be explained partly by the costs, as previously noted, but also by the allocation. It is striking that sustainable funds invest slightly less often in large-cap US equities, or large American companies. And this is precisely the category that has done well in recent years.

Opinions are strongly divided about what the present results say about the long-term return. Those in favour of sustainable investment,

PROSPECTUS NET EXPENSE RATIO, RELATIVE TO CUMULATIVE ASSETS



for example, claim that the current offering is still too new to be able to draw any hard conclusions. The return histories also often do not include a complete economic cycle.

The argument is that sustainable investments may well do better than traditional ones when the economic climate is less favourable.

The fact is that in terms of allocation to companies or their exposure to market risks, sustainable funds essentially appear to be no different than traditional funds, which implies that the expected impact of the economic cycle on the sustainable return is also not likely to be very much different.

SCORES SAY LITTLE

Ratings play an important part in determining the sustainability of funds and companies. But is there also a link between the rating and the return? To establish that we compared these two factors for sustainable funds in Europe. The unavoidable conclusion was that there is no relationship between ESG scores and return over the last five years (Graph 3).

Funds that currently have a high ESG score, historically show no better return. This leads to the conjecture that any benefits of sustainable investment have already been widely discounted in pricing, or that there may be less of a relationship than has been assumed. There was also no discernible link when shorter periods (such as two years) were looked at.

The lack of any link between return and ESG rating may have to do with the short history of ratings. This makes it all the more interesting to continue monitoring the development of more sustainable funds in relation to returns. If this sector wants to maintain its credibility then comparable information which can be easily interpreted will be just as vital as achieving good returns.

COSTS HELP TO EXPLAIN DISAPPOINTING RESULTS BUT ALLOCATION IS ALSO A FACTOR

LINK BETWEEN RETURN AND ESG SCORES

The point cloud shows that statistically there has been no relationship between ESG scores and returns over the last five years. This means that on average funds with a high ESG score perform no better in terms of return.

RETURN ON SUSTAINABLE FUNDS (5 YEARS, AFTER DEDUCTING COSTS, IN PERCENT)

The box plot below shows the return spread per category. It gives the average return for that category. The lines and circles outside the square show the minimum and maximum values falling outside the first and third quartile.